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Of Bureaucrats' Brothers-in-Law and Bankruptcy Taxes: Article 9 Filing Systems and the Market for Information

James W. Bowers*

It has been . . . suggested that modern techniques for the collection and communication of credit information have made filing systems unnecessary and obsolete. A businessman or banker, it is said, in determining whether to extend credit or make a loan relies, not on public records, but on financial statements—balance sheets and profit and loss statements—submitted to him or to a specialized credit information agency by the prospective borrower. Public files, even if they are easily available, will be rarely consulted; they can in any case never be relied on since no filing system, including that established by Article 9, is comprehensive in the sense that a check of the files will reveal all possible encumbrances . . . Since these statements are the best available, indeed the only available, sources of comprehensive credit information, and since they are in fact regularly relied on in granting credit and loans, they should, the argument runs, be made the basis of a truly modern system of creditor protection: public files should be scrapped and appropriate safeguards introduced to protect people misled by false or incomplete statements.

Grant Gilmore¹

Scholars interested in understanding the justification for the creation of state agencies often begin to develop their insights by examining the role of government. The literature seeking to understand the public filing system created by Article 9 of the Uniform Commercial Code (UCC), however, has neglected this perspective. In fact, the debate over the filing of notice of security interests illustrates a fundamental disagreement among scholars about the proper role of legislation. For in-

* Professor of Law, Louisiana State University Law Center. I am grateful to Richard Epstein and Robert Ellickson for conversations that pointed me toward the thoughts developed in this study. The benefit I obtained from my friendship with Richard J. Dodson, a distinguished admiralty practitioner, will be obvious to my readers. I also had important guidance along the way from John Bigelow, John Church, Dean Lueck, Andy Klet, Lucy McGough, and especially Bill Hawkland. Those who offer directions, however, bear no responsibility for any wrong turns that occur on the trip. I take responsibility for having been the driver.

1. 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 463-64 (1965).

stance, some view government as necessary to solve collective action problems.² They believe that when markets cannot supply the optimal level of services, it is desirable to have the government supply them. Government, according to this view, positively contributes to social welfare by fostering optimal levels of cooperation among the participants in a society. In theory, the Article 9 filing system might be viewed as just such a measure.

Disquiet is growing, however, about this sanguine belief in the beneficence of governmental regulation of commercial law. Theorists who share this rising level of concern subscribe to a more skeptical view of the value of bureaucracies. They suspect that governments exist largely to permit politically victorious bureaucrats and interest groups to exploit the rest of society.³ One way of demonstrating that these suspicions are realistic is to show that the existing explanations for the Article 9 filing system are implausible, and that the system is not a credible response to any well-recognized type of collective action problem.⁴ That is the task that I undertake in this Article.

In Part I, I briefly outline the history of the most recently adopted version of the Article 9 filing system, that of Louisiana. In Part II, I ask whether the filing system actually advances welfare better than the market for information acting alone. I argue that there is little reason to believe that we need legislation to foster the appropriate level and kind of cooperation among those dealing in our financial markets, and urge that there is much to suggest that the filing system is little more than a rip-off. In Part III, I posit that even if these concerns are unjustified, and a filing system might theoretically enhance welfare, there remains the question of whether the existing system is well designed to do so. I argue that the existing system offers a costly and ineffective way of delivering whatever social benefits filing is supposed to provide for us. I also question the wisdom of what appears to be a growing consensus that we need a

2. See, e.g., RICHARD E. WAGNER, *PUBLIC FINANCE* 130 (1983) (describing a model that views government as a means to provide some services more efficiently than the free market).

3. *Id.*

4. That the filing system may be the result of such exploitation does not condemn it, of course. For example, those who object to secured lending will not wish to resist permitting those engaged in the practice from being exploited. Thoughtful opponents of secured lending, however, might not be enthusiastic about wasteful measures that discourage the practice if there were cheaper means of making secured lending appear undesirable to prospective lenders and borrowers.

whiz-bang, national, centralized computerized system. In Part IV, I argue that *the troubles with the system are organizational, not technological*. I urge that private, local filing systems would be likely to deliver services most efficiently. Technological issues tend to solve themselves once we provide the proper organization. Indeed, an appropriately designed organizational structure would minimize the damage done by an exploitative filing system.

I accept, in this Article, the assumption of the revisors of Article 9 that permitting parties to contract for security interests fosters socially beneficial conduct to the extent that secured lending ought not to be made more difficult or expensive as a matter of UCC policy.⁵ I conclude, however, that the proper application of such a policy would mandate that the requirement for filing be lifted from the backs of those who contract to grant or take security. Because the filing system exploits secured lenders and borrowers, it should be abolished in order to eliminate the exploitation, or at least reorganized to minimize the level of bureaucratic brigandage.

I. THE LOUISIANA COMPROMISE: AN HISTORICAL VIGNETTE

Louisiana, where I live, was the last of the fifty states to adopt Article 9 of the UCC.⁶ Were we twenty years late in adopting this legislation because our bankers and borrowers failed to see it as an improvement over a pre-code security device system that resembled the systems Article 9 replaced in our sister states? Almost assuredly not. Louisiana is home to a large oil industry and is the source of significant commerce transacted at the outlet to the Mississippi, and thus needs a modern commercial law as sophisticated as that of any state. In addition, for years prior to our enactment of Article 9, our local member on the National Conference of Commissioners on Uniform State Laws (NCCUSL) was William D. Hawkland. Not only was he the chancellor of our state's flagship public law school, perhaps

5. See PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, PEB STUDY GROUP, UNIFORM COMMERCIAL CODE ARTICLE 9: REPORT 8-9 (1992) [hereinafter PEB REPORT] (recommending that those opposing the institution of secured lending do so by amending the Bankruptcy Code or changing the priority rules directly instead of simply making it expensive to perfect security interests).

6. LA. REV. STAT. ANN. § 10:9-101 (West 1988) (effective Jan. 1, 1990).

the most famous UCC scholar in the country,⁷ and a well-known long-time member of the Permanent Editorial Board to boot, he was also an unceasing advocate and lobbyist for Article 9 in the Louisiana legislature.

What delayed the adoption of Article 9 in Louisiana was the implacable opposition of the Louisiana clerks of court. More perhaps than many states, Louisiana possesses a fully flowered local spoils system; political power resides at the courthouses. Under our pre-code security device law, parties filed multiple-page security contracts in full with the local clerks. At a one-dollar-per-page filing fee, clerks historically earned a stream of revenue that enabled them to supply employment to their political allies and brothers-in-law.⁸ They were understandably reluctant to see this pre-Code revenue stream replaced by a three dollar fee for a one-page UCC-1⁹ for each transaction, especially were it to be filed with the secretary of state under Article 9, instead of the local courthouse organization.

Multiple-page, multiple-location filings provide far better sources of revenue for a spoils system than Article 9. Article 9's adoption in Louisiana, then, became contingent on a formula that would preserve the spoils system. A deal was struck. Filing fees for a financing statement in Louisiana are fifteen dollars per form,¹⁰ and most of that money is paid to the local clerks of court. The balance goes to the secretary of state, who maintains a technologically whiz-bang, computerized, central filing system.¹¹ All filing is done, however, with the local clerks, who simply fax copies of all the financing statements to Baton Rouge, collect the fees, live off the float, and eventually pay the secretary of state his or her share.¹²

7. See, e.g., WILLIAM D. HAWKLAND, *UNIFORM COMMERCIAL CODE SERIES* (1982) (multi-volume treatise).

8. In folklore, the term a "brother-in-law" deal, which suggests something less than an efficiency driven arms-length transaction, is not unique to Louisiana. By employing this linguistic convention I do not mean to imply that the Louisiana court clerks are necessarily sexist. Many of the parties to their brother-in-law deals are undoubtedly sisters-in-law, daughters-in-law, and mothers-in-law as well. Inasmuch as I have never perceived a strident demand by those who insist on gender neutral modes of expression for identifying corruption as closely with female as male actors, I employ the masculine term here strictly on account of a reader's likely familiarity with it.

9. U.C.C. § 9-402 (1990).

10. LA. REV. STAT. ANN. § 10:9-405(2).

11. WILLIAM D. HAWKLAND, *HAWKLAND'S HANDBOOK ON CHAPTER 9 LOUISIANA COMMERCIAL LAW* § 4:08, at 21 (1989).

12. *Id.* § 4:08. The Louisiana system, which puts all the fees received at the disposal of the bureaucracies that collect them, may not be typical. The

Chancellor Hawkland had advocated that Louisiana adopt an even more technologically advanced filing system, in which every lawyer with a computer and a modem could file electronically, directly with the secretary of state's central computer, and could also search the filings from her own desk. Sadly, however, Louisiana's secured parties are walking to the fax machine at the courthouse as a tribute to the spoils system. This history is probative of the point I raise in this Article: The Article 9 filing system is little more than a rent-seeking device.¹³

II. THE ARTICLE 9 FILING SYSTEM IS PROBABLY UNNECESSARY; IF ITS SERVICES WERE TRULY VALUABLE, THE MARKET WOULD EFFICIENTLY PROVIDE THEM

The Article 9 filing system provides nothing other than a simple commodity—information.¹⁴ The market for information could probably efficaciously do whatever the filing system bureaucracies do and at a lesser aggregate resource cost. The system is justifiable only if it is the most efficient way of providing the services we ask it to perform; the system should deliver benefits that equal or exceed its costs. There are serious theoretical and empirical reasons to believe that the current filing system probably does not deliver its services efficiently.

polar opposite is found in Minnesota, where all fees collected are added to the general revenue accounts of the state and the expenses of running the filing system are paid for by legislative appropriations to the appropriate bureaucracies. Telephone Interview with Katherine A. Engler, Staff Attorney for the Minnesota Secretary of State (Oct. 1994). Whichever funding mechanism a state chooses, however, there is reason to believe that on the whole, the filing system is used as a revenue-raising measure. *See infra* note 13 and accompanying text (discussing political impetus to charge filing fees).

13. Other scholars have recently seemed to be coming to agreement on this argument. *See, e.g.,* Douglas Baird, *Security Interests Reconsidered*, 80 VA. L. REV. 2249, 2271 (1994) ("Radical change that is desirable in theory may not be desirable in practice, because of the uncertainties inherent in implementing new ideas. Even if we desired such change, the political forces that are in place may prevent even the most sensible reforms in such things as the filing system."); Paul M. Shupack, *On Boundaries and Definitions: A Commentary on Dean Baird*, 80 VA. L. REV. 2273, 2273 n.1 (1994) (noting difficulty in making changes "in the face of entrenched people whose interests are served by continuing the present system. The Study Group heard reports from knowledgeable people that running the [UCC] filing system costs states collectively between \$500,000,000 and \$600,000,000 annually. That same system raises about \$900,000,000 for the several states.").

14. *Cf.* 1 GILMORE, *supra* note 1, at 463-64 (indicating that Gilmore also views filing as an information-providing device).

A. FILING SYSTEMS ARE INEFFICIENT BY DESIGN

A glance at the legal explanations offered to justify filing systems in general, from those that govern real estate transactions to those that deal with personal property, reveals that such systems are theoretically inefficient *by design*. Transacting parties must file before they can make the benefits of their dealings enforceable *against strangers*. Those strangers who benefit from the filing system are, in theory, quintessential external beneficiaries. External benefits, like external costs, produce suboptimal resource allocations.¹⁵

Creditors are apt to differ in the degree to which they rely on the debtor's ownership of discrete assets before they agree to make any loans. Secured parties are likely to rely more heavily than others. Unsecured creditors who obtain judgments and levy on a debtor's assets are less likely to have relied on the fact that the debtor had clear title to any given asset when they advanced credit to the borrower. Article 9 treats the likely reliers more favorably than it treats the likely nonreliers.¹⁶

The flip side of this argument is that future secured lenders, without the information that the filing system provides them, might rely on having a first claim to already encumbered assets, and thus have external costs imposed on them by earlier secured lenders. Future secured lenders are assumed to be able to protect themselves if they have notice of a prior security interest and if the filing system is capable of delivering them the necessary notice. Absent a filing system, however, these future secured lenders would not necessarily be so uninformed as to be required to bear external costs.

Creating a filing system, on the other hand, may make them into external beneficiaries. Because a lender ends up contracting with the borrower who possesses information that the lender desires, a natural mechanism exists that assures that the future lender could be induced to pay for the value of the infor-

15. The existence of externalities, in one form or another, commonly justifies having a service provided by the government rather than the market. I therefore postpone analysis of this apparent theoretical defect inherent in filing systems until Part IV, which addresses the potential for reorganizing the way public agencies should run the system they have inherited. In this Part, I will address the more direct costs and benefits that, it has been posited, might flow from filing systems in general.

16. It is at least plausible, for example, that the reason lien creditors lose to perfected secured creditors, *see* U.C.C. § 9-301(1)(b), is that the secured creditor more likely relied on the existence of the collateral in the decision to extend credit than did the lien creditor.

mation he or she needs or desires. The current system, however, has the future lender paying search fees to a bureaucracy rather than buying the necessary information from the borrower and agreeing to pay for it in setting the loan price term. The filing system thus turns potential contractors into potential free riders. It also makes the previous secured lender a *forced rider*.¹⁷ As a result, no one but the most optimistic fan of bureaucratic decision making is apt to believe that the system is likely either to collect or to disseminate the optimal quantity and quality of information.

If the system was set up so that the users of the information paid for the value they receive, we might draw a contrary conclusion. If we assume that filers can costlessly provide the information the system requires them to disclose¹⁸ and that the fees paid by the system *searchers* pays the cost of the system, we would have some assurance that the system produced optimal results. The irony of the current system, however, is that its costs are probably paid not by the *consumers* of the information in the form of search fees, but rather by the *providers* of the information in the form of filing fees. This fact alone makes a *prima facie* case that the system is not producing efficient outcomes.

17. The costs imposed on the earlier lender who is forced, by a filing requirement, to grant free information to his or her successors, may in fact be shared between lenders and borrowers, depending on whether there are many lenders bidding for the privilege of lending to few borrowers, or on whether there are many borrowers bidding for the privilege of obtaining loans from few lenders. In the latter case it is borrowers who are the forced riders.

18. This is an heroic assumption. Historians of filing systems have opined that disclosure of private information was costly to the disclosing party, which may have contributed to the desuetude of early filing systems. See, e.g., R.E. MEGARRY & H.W.R. WADE, *THE LAW OF REAL PROPERTY* 173 (1966) (pointing out that the advantages of avoiding a recording system include avoiding publicity); *id.* at 1047 (pointing out that modern English Land Registration records are not made available for public inspection). That disclosure is costly is also recognized by modern-day economic theorists. See, e.g., EDMUND W. KITCH, *THE LIMITS OF ACCURACY ENHANCEMENT AS THE PURPOSE OF THE DISCLOSURES REQUIRED BY THE SECURITIES LAWS* 50 (University of Va. Sch. of Law, Legal Studies Workshop, Working Paper No. 94-5, Sept. 2, 1993) (pointing out that disclosure will not occur when firms find that secrecy is valuable to them).

B. ARGUMENTS THAT FILING SYSTEMS PRODUCE EFFICIENT EFFECTS ARE IMPLAUSIBLE

Richard Epstein offers the most intriguing review of the economics of recording systems.¹⁹ Although his analysis focuses on fractionalized interests in real property (servitudes), what he has to say easily applies to personal property filing systems like that imposed by Article 9. His analysis is problematic, however, whether applied to real or personal property.

1. Grantor-Grantee Indexed Filing Systems Probably Do Not Reduce Search Costs

Epstein's first argument is that recording systems cut down the search costs of strangers desiring to bargain for property.²⁰ In the marginal case, a recording statute might plausibly reduce some search costs, particularly under systems in which ownership interests rather than mere encumbrances are recorded. This is not likely to be true, however, for the sort of filing system that has typically been adopted for both real and personal property security interests. To illustrate, suppose I see the Happy Acres Estate and desire to make an offer to buy it. A trip to my local courthouse, where I can consult only a grantor-grantee indexing system in the land records, will not assist me. To use such a system, I have to start with the name of a grantor or grantee. Nothing in the recorder's office is indexed under "H" for "Happy," so the system is unlikely to save me significant search costs in identifying the owners. A title registration system, which is relatively rare, or, more probably, a visit to the tax collector's office, where records are indexed by tract instead of by party, will give me better information than the filing system about whom I need to see in order to open negotiations.

Owners soliciting offers for their assets typically publicize their ownership and their desire to enter into bargains in a local market, rather than rely on the official record of their title as a contact point between themselves and potential searching bargaining partners. If search cost savings sufficiently benefited potential buyers and sellers of interests in assets, we would observe a strong, persistent demand for systems of title registra-

19. Richard A. Epstein, *Notice and Freedom of Contract in the Law of Servitudes*, 55 S. CAL. L. REV. 1353 (1982).

20. *Id.* at 1354 ("The real problem . . . arises when a third party wishes to acquire an ownership interest in the subject property. The initial problem he must face is to determine with whom he should deal. . . . A system of recordation reverses this general rule . . .").

tion. The history of recording systems, then, would not be the story of evasion of such systems.

2. Filing Systems Probably Do Not Significantly Lower Authentication Costs

Epstein also contends that recording systems reduce the costs incurred by any claimant of a fractional interest in property to prove that her title is valid because her predecessor's was also valid.²¹ This empirical assertion, however, is belied by the history of recording systems. There probably are efficient ways to authenticate a claim in the absence of a recording scheme. Authentication costs would predictably be highest in the case of long-lived assets that require proof of the occurrence of ancient transactions. Recording schemes would thus seem much more important for land than for personalty. The history of recording of interests in land, however, is not a testament to the efficacy of filing systems in reducing authentication or any other sort of costs.²²

There are those even now of the opinion that participants in the real estate market rely less on recording systems than on alternative assurance techniques available to them in information markets.²³ Counsel representing lenders typically demand the opinion of the borrower's counsel that the lender's mortgage will constitute a valid first lien on the collateral, and counsel representing the borrower frequently render such opinions without, necessarily, wholly relying on the public records.

Although ship mortgages must be filed to maintain their preferred priority level, there has long been a host of maritime liens that are enforceable against vessels (and that will even take priority over a preferred ship mortgage) without ever being

21. *Id.* at 1354-55 ("Who will be prepared to buy a remainder interest or to accept property as security for a loan, if faced with the specter of having to authenticate title in a subsequent proceeding brought by a disappointed rival claimant to the fee?").

22. *See infra* part II.C (summarizing history of recording interests in land). Indeed, recording of land titles did not become common on the Continent until the middle of the 19th century and in England until 1925. *See, e.g.,* ALEJANDRO M. GARRO, *THE LOUISIANA PUBLIC RECORDS DOCTRINE AND THE CIVIL LAW TRADITION* 46-48 (1989) (discussing the enactment of the Law of Transcription in 1855 in France); *id.* at 65-66 (discussing the enactment of the English Land Registration Act in 1925).

23. "The United States . . . is probably the only country in the world where title security rests less on a public registry than in the hands of a private industry composed of attorneys, abstractors, and title insurance companies." GARRO, *supra* note 22, at 4.

recorded.²⁴ Nevertheless, the purchase and construction of sea-going vessels, which are particularly large and expensive sorts of capital equipment, have been possible by resort to the market for information, without relying on a recording system. Intriguingly, the official registration systems that exist for vessels seem designed to serve *efficiently* the financiers likely to use them. When nations must compete with one another for the privilege of offering ship registry services, they are likely to design their services so that they are convenient to potential ship-owner customers. For instance, one can register a vessel to carry the Liberian flag, record mortgages against the vessel, and make other required filings by depositing the paperwork, not in Monrovia, but rather in New York City.²⁵ The Republic of Vanuatu, similarly, maintains its ship registry offices in New York.²⁶

Particularly in the case of Article 9, it has long been known that assurances of the validity and priority of a security interest can be given only when facts not evident from the filing are known. Lender's counsel needs to determine, among other things, that: (1) the borrower actually owns the collateral and has had possession for longer than ten days; (2) the collateral has been constantly within the jurisdiction for at least four months; (3) the collateral was not purchased with the proceeds of other validly pledged collateral; (4) the collateral is not in the possession of any other secured party; and (5) the borrower's name has not changed in the recent past. These facts, and several others necessary to assuring the priority of a client's security interest, are simply not apparent from public records.²⁷ Since Article 9 was adopted, lenders who need this information have been obliged to obtain it, not in the filing system, but instead in the market for information. In many cases, it may be true that the information furnished by an Article 9 filing would be a joint product of the process that produces the unfiled infor-

24. See, e.g., WILLIAM TETLEY, *MARITIME LIENS AND CLAIMS* 399-403 (1985).

25. REPUBLIC OF LIBERIA, BUREAU OF MARITIME AFFAIRS, *REQUIREMENTS FOR VESSEL REGISTRATION AND RECORDING OF INSTRUMENTS* part I, § A 1 (1989).

26. REPUBLIC OF VANUATU, *SHIP REGISTRY AND FINANCIAL SERVICES REGULATIONS* ch. 1, § 1 (1990).

27. See, e.g., Lynn M. LoPucki, *Computerization of the Article 9 Filing System: Thoughts on Building the Electronic Highway*, *LAW & CONTEMP. PROBS.*, Summer 1992, at 5, 6-15 (discussing the relevance of the foregoing facts in detail and citing other studies arguing that the information provided by the Article 9 system is unreliable).

mation,²⁸ in which case the net gain from the administrative procedure of filing is nearly zero.

C. THE INEFFICIENCY OF FILING SYSTEMS IS INFERABLE FROM THEIR HISTORY

That recording systems are likely to provide search cost and authentication cost savings is most plausible in the case of relatively more valuable assets, particularly those assets having very long lives. For example, ownership may turn on ancient facts that are expensive to prove. The history of recording of interests in land, however, seems inconsistent with the hypothesis that grantors and grantees might rush to record in order to capture the increases in land values occasioned by the savings in search and authentication costs. The history of land recording systems in England is so colorfully to the contrary that it is worth summarizing here.

The first general British statute requiring the recording of conveyances in interests in land was the Statute of Enrollments, enacted in 1535.²⁹ It provided that no "bargain and sale" conveyance of a freehold was effective against a third party, unless it was in writing and enrolled in one of the king's courts.³⁰ From and after 1535, however, conveyancing lawyers in England adopted the technique of conveying land by "lease and release," under which the buyer leased the land and, after entering into possession, obtained a release of the reversion from the "seller." The result conveyed a fee simple estate, but because the conveyance was not by bargain and sale, it was not subject to the recording requirement under the Statute of Enrollments. Lease and release became the standard mode of land transfer in England, such that by the nineteenth century, conveyances could take the form of the release of the reversion of a nonexistent, totally fictional lease!³¹ Conveyance by deed did not become common until the nineteenth century, and recording was not required in England until the early twentieth century. Even though the sorts of interests and the value and longevity of the

28. Cf. KITCH, *supra* note 18, at 9-10 (arguing that the disclosure requirements in securities laws may be justified because the information, being a product of normal record keeping, is nearly costless for issuers to produce but is highly valuable to existing and potential investors).

29. 27 Hen. 8, ch. 16 (Eng.).

30. Prior thereto, land had been conveyed mostly by the strictly oral and physical ceremony of enfeoffment (livery of seisin). The Statute of Frauds, which required that conveyances be written, was not enacted until 1677.

31. This history summarizes MEGARRY & WADE, *supra* note 18, at 171-74.

assets involved make the case for filing systems most intuitively appealing, history does not attest to their probable efficiency.

D. THE FILING SYSTEM OPERATES AS A BANKRUPTCY TAX

If filing is costly to filers and provides a free ride for information users, the mystery arises—why does anybody file? The foregoing analysis predicts that while mortgagees might take their interests in recordable form, they will not voluntarily record them. Under the current law of nonbankruptcy creditors' remedies, all the mortgagee needs to do is monitor whether the mortgagor is a defendant in any litigation. If the mortgagee incurs any judgments, the mortgagee can then file before any judgment creditor obtains an execution writ, delivers it to the sheriff, and gets the sheriff to seize the collateral. Consequently, no creditor needs to file until after the debtor has suffered an adverse judgment. The filing fees and disclosure losses may be smaller than the cost of monitoring the debtor for such litigation, of course, but perhaps not in all cases. Even so, mortgagees can invest in locating assets on which they believe they can file before a sheriff will be able to locate them and thus can monitor for judgments alone.

What has made this strategy for saving the filing expense too risky for lenders in the last century is the misguided determination of Article 9's drafters to make priority among secured parties turn on the dates of filing.³² Even if the drafters were to rescind their decision to pick first filers as winners in Article 9's priority race contests, however, the strong-arm clause of the Bankruptcy Code would still compel filing.³³ What must be monitored in a bankruptcy regime are not objective events, like ongoing litigation, but rather the subjective likelihood that the borrower will file a bankruptcy petition. If he or she does, the provisions of the Bankruptcy Code operate as if a judgment creditor had been able to employ Tinker Bell as the sheriff. Tinker Bell levies by sprinkling pixie dust into the wind. The wind blows the dust onto all assets, no matter how hard they

32. U.C.C. § 9-312(5). Because the possibility of future filing secured lenders or purchasers is harder to determine than is the possibility of judgment creditors, risk-averse lenders will always have a strong inducement to file. On the other hand, what new lenders and purchasers take out of the debtor's estate is likely to be replaced in part by new assets that the lenders and purchasers contribute. One can thus argue that it would be less critical for early secured lenders to monitor for these later transactions than it is to monitor for judgments, which can subtract assets without adding any.

33. 11 U.S.C. § 544(a) (1988).

would be for a real creditor and his or her real sheriff to find and seize. The assets, of course, fly away once Tinker Bell coats them with the dust. Filing is thus the only alternative available to a lender to protect whatever inframarginal rents for which it has contracted in the loan transaction.

The filing system consequently operates as if it were a tax on secured transactions. In the ongoing debate as to whether the costs of the bankruptcy system are significant, then, one should add the cost of maintaining and using the filing system. Without bankruptcy law, one could conceivably evade the tax. There is good reason to believe that bankruptcy legislation is intended mainly to chisel secured creditors out of their bargains. More likely, it only results in making secured financing more expensive by raising the costs of secured transactions.³⁴ The efficiency losses resulting from the artificial inflation of the costs of these transactions are exceedingly difficult to quantify. The direct costs of the filing system, however, are determinable, and should be added to the bankruptcy cost ledger in the debate over the costs of bankruptcy.³⁵

III. THE CURRENT SYSTEM, EVEN IF JUSTIFIABLE, OUGHT NEVERTHELESS TO BE REORGANIZED—ITS PRIMARY PROBLEMS ARE ORGANIZATIONAL, NOT TECHNOLOGICAL

Even if we assume that the Article 9 filing system creates net welfare, it is still legitimate to ask whether it delivers as much welfare as it is capable of delivering and, if not, whether it minimizes the welfare losses that it otherwise imposes. Whiz-bang computer programs, changes in the place-of-filing rules, and other technological monkeying with the system seem directed to this latter question. If the system is inefficient, there is good reason to reduce the cost of the services it does provide, and to enhance their value as well.

Nevertheless, whatever is technologically wrong with the system can be rendered largely unimportant. We can mitigate or cure any serious problems that filing systems create by or-

34. Cf. James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses*, 72 WASH. U. L.Q. 955, 965-67 (1994) (critiquing the hypothesis that Chapter 11 bankruptcies redistribute the wealth of secured parties).

35. This argument is implicit in Professor White's proposal to amend Article 9 so that unperfected secured creditors' claims will take priority over trustees in bankruptcy under the strong-arm clause. James J. White, *Revising Article 9 to Reduce Wasteful Litigation*, 26 LOY. L.A. L. REV. 823, 823-25 (1993).

ganizing them better. A properly privatized system, for example, encourages those who own the system to adopt any advantageous technologies, without a legislative mandate. The Article 9 Study Committee recommends that the redrafters of Article 9 consider amending it to permit the privatization of the filing system.³⁶

A. THEORIES JUSTIFYING PUBLIC OWNERSHIP AND OPERATION OF SERVICES DO NOT JUSTIFY THE CURRENT FILING SYSTEMS

The unvarying feature of the current Article 9 filing system is that public officials keep the files. Every state's section 9-401 designates one or more public officials' offices as the exclusive places where secured parties must give notice of the existence of their security interests. Several social scenarios exist under which the decision to have public officials provide economic services is regarded as rational. None, however, provides a very strong justification for the existing Article 9 filing system. In this section, I examine whether any of the four generally accepted reasons to have services provided by a government applies to the Article 9 filing system.

1. The Case of Public Goods and Free Riders

Filing systems must be justified as systems to communicate information. Indeed, there is a naive view of information economics that might seem to provide some theoretical support for their necessity. Information has long been recognized as an economic resource or asset, but one which also possesses the qualities of the quintessential public good. It is nonrivalrous and nonexclusive in its essence; that is, the use of information by one person does not preclude its use by limitless others.³⁷ If information is a public good, the first postulate of the economics of information is that information will be chronically underproduced, because those who bear the costs of producing it cannot exclude free riders. Accordingly, it would be justifiable for us to establish subsidies to increase the production of public

36. PEB REPORT, *supra* note 5, at 90 ("The Drafting Committee may also wish to consider textual changes that would facilitate or make possible . . . the privatization of a state's filing system.").

37. JOHN F. DUE & ANN F. FRIEDLAENDER, GOVERNMENT FINANCE: ECONOMICS OF THE PUBLIC SECTOR 25-26 (7th ed. 1981).

goods. Ironically, however, our existing system functions not as a subsidy but as a tax.³⁸

If borrowers and lenders, left to their own devices, will underproduce valuable information, one might argue that it is possible to correct directly the perverse incentives that lead to underproduction. What borrowers and lenders will not voluntarily disclose, we will force them to make public. The fallacy in this approach, however, is that the information is not a public good until *after* it has been conscripted. The problem that gives rise to the perverse incentives of a public good is the infinite costliness involved in excluding free riders from the benefits of the good. Possessors of information, on the other hand, have a less expensive means of excluding free riders. They can simply choose not to reveal their information to anyone who does not pay for it. Thus, it is not the inherent quality of information that leads to a free rider problem in information about the ownership of assets. It is the conscription itself that produces the public goods problem.

2. Public Regulation and Negative Externalities

The public goods case for the governmental provision of services is founded on the supposed problem created by positive externalities—free riders. The converse of this position is the need for public regulation of activity that, if furnished by markets, would impose significant *negative* externalities. Indeed, the standard legal argument for requiring a filing in order to perfect a security interest against third parties takes this form. If third parties might detrimentally be misled into dealing with a debtor by the secrecy of a security interest, then a publicly run filing system can provide an antidote to this risk of a negative external effect on the ignorant third party.³⁹ Disclosure by the secured lender, this argument assumes, permits the third party to protect itself more cheaply than any other technique it has available to it.

For the current Article 9 filing system, and some of its analogues, these assumptions turn out to be heroic. The negative externality rationale may explain why we ought to require dis-

38. See *supra* text accompanying note 33 (discussing the strong-arm clause of the Bankruptcy Code).

39. Douglas G. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53 (1983) (arguing that filing systems eliminate the external effects of creditor reliance on the debtor's "ostensible ownership" of the collateral). But see Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (contending that Baird's conclusion was in error).

closure, but not why filing with public officials is the most efficient way to effectuate disclosure. There is every reason to believe that disclosure to a local, privately run credit bureau would be at least as cheap and effective a way to protect the at-risk third parties. What is more, at-risk third parties are in a position to protect themselves and, indeed, seem routinely capable of doing so. Article 9, in fact, assiduously separates future third parties who might be relying on the lack of information about the existence of a security interest from those who, presumably, are less likely to be relying third parties.⁴⁰ Ironically, the trustee in bankruptcy, the least likely of all to have been a misled third party, is the most likely beneficiary of the filing requirement.⁴¹

In particular, if the information that filing discloses is valuable to third parties, then there is good reason to require the third parties to pay for the value they receive. Only if they do, are we likely to develop a reliably efficient equilibrium quantity of disclosure. Indeed, it is precisely because the public officials running the filing system charge not only the consumers, but also the providers of the information, that we can conclude the filing system is both inefficient and explainable primarily as a rent-seeking exercise of governmental power. If there was money to be made collecting the information and selling it, the market would undoubtedly have provided collection and disclosure services without the need for legislation. In short, the case for requiring filing with a public agency because of the existence of negative externalities is, at the very best, an extremely uneasy one.

3. Redistribution

The next excuse for having a public agency provide any service is that the service is an ideal fulcrum for applying the leverage of an income redistribution policy. No one, however, is arguing that the Article 9 filing system was planned or is justifiable on this basis. Among other reasons why redistribution does not credibly justify the filing system is that the most typical

40. See *supra* note 16 (noting that creditors' probability of reliance may explain Article 9's priority scheme).

41. David Gray Carlson, *The Trustee's Strong Arm Power Under the Bankruptcy Code*, 43 S.C. L. REV. 841, 912-20 (1992) (arguing that the strong arm power, in the name of eliminating secret liens, also promotes strategic behavior in bankruptcy, and creates windfalls to nonrelying claimants); White, *supra* note 35, at 826-30 (arguing that it is fair to subordinate bankruptcy trustees to unperfected security interests).

filers and users seem to be the same people—banks. The most plausible redistributive analysis of the structure of the filing system, then, seems to be that it is designed to take value from people, pass it through the pockets of bureaucrats, and return most, but not all, of the value to the initial contributors. While calling a rent-seeking structure redistributive might be technically accurate, it is nevertheless normatively unattractive as a justification.

4. The Existence of a Natural Monopoly

The last widely accepted justification for the policy of providing services through a public agency is that the marginal costs of the services are continuously declining at the levels of output that will credibly be demanded. The provision of such services will, in equilibrium, eventually be furnished by a single firm, a natural monopoly.⁴² So long as the services are provided at their marginal cost, furnishing them through a monopoly is desirable, although markets will not induce monopolists to price their product at their marginal costs. If public agencies operate the monopoly, it might be thought, then political will could affect prices and keep them at the marginal cost levels.⁴³ It should be noted, however, that it would be difficult to argue that natural monopoly considerations justify the existing system. Although local filing seems irrational under natural monopoly conditions, it is not atypical. If we take natural monopoly considerations seriously, there is some reason to think that pressures to federalize the system or treaty proposals to create multi-state central systems would have been vigorously pushed.

Finally, there is very little reason to believe that the public agents who furnish the services of the filing system today, or have been doing so for the last thirty years, have been modifying their prices to continuously assure that they reflect the marginal cost of the services. Indeed, there is reason to believe that granting the monopoly to bureaucrats does not create any particular incentives for the bureaucrats to price their services efficiently. Thus, the natural monopoly justification for the use of public agencies to provide services is not likely to apply credibly to the case of the Article 9 filing system.

42. DUE & FRIEDLAENDER, *supra* note 37, at 91-93.

43. I reveal below why there is some theoretical reason to believe that the provision of information through a filing system might be a natural monopoly. I also make recommendations to redesign the filing system to minimize the dead weight costs imposed by the monopoly.

B. THE BENEFITS OF ORGANIZATION

1. The Question of How Fees Are Set

A system like that adopted in Louisiana protects the local filing interests while providing all the technological benefits of central filing.⁴⁴ One might argue, then, that the Louisiana Compromise represents a triumph for efficiency, except that it lacks a critical organizational feature. The triumph of the Louisiana clerks was not so much in the requirement of continued exclusive local filing. Rather it was the decision to have the fees for filing set by the legislature! If any secured party doing a deal in Shreveport is authorized to file in New Orleans, or vice versa, then the possibility exists that the clerks of all the parishes might be thrown into competition with one another. Had the new filing system permitted the Louisiana clerks to set their own fees, one could expect the forces of competition to have set an equilibrium price for the services of the filing system at a level approaching their marginal costs. Brothers-in-law might have found continued employment in such a system, but only if they were efficient workers. Indeed, if we could write network programs to access the filing information compiled by each local clerk, we would not need central filing. The resulting system would deliver the goods that filing systems provide under competitive conditions, assuring us efficient results.⁴⁵

2. The Possibility of Technological Efficiencies

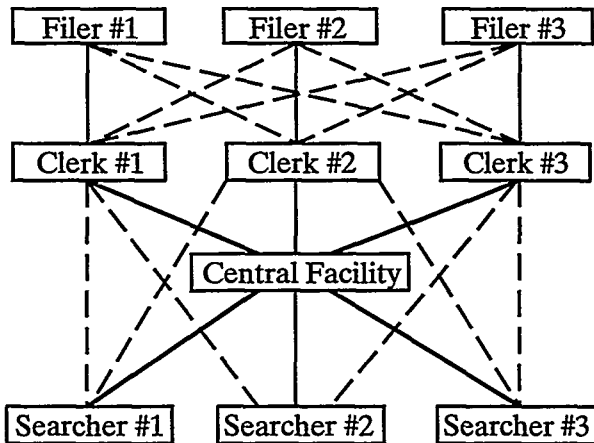
It might appear that the technology is such that large, central computer databases provide filing and searching services at lower cost than networks, largely because the centralized system minimizes the number of communication channels that the system needs. The diagram below illustrates the number of

44. See *supra* part I (discussing Louisiana's filing system).

45. When the clerks are given a monopoly over the services at a rate fixed by law, there is reason to believe that the monopoly rents can still be dissipated as long as the system places the clerks in competition with each other. It is, for example, worthwhile for the clerk of a parish distant from a commercial center to spend resources advertising its services, or offering under-the-table considerations to the lenders and borrowers at that center, to convince them to do their filing farther away from home. The possibility exists that nonprice competition provides services to the filers at something close to the net cost approximating the marginal costs of the services. Were this true, however, one would then expect the clerks to find it fruitless to have the legislature fix the prices for filing and searching. The shape of the legislation adopted indicates that that is not the case. There is, nevertheless, some anecdotal reason to believe that a few Louisiana clerks are indulging in some nonprice competition in the offering of credit terms, free courier services and the like to large-volume filers.

communication channels required of a system organized like Louisiana's, with three local clerks, a central storage and search facility, and three searchers.

POTENTIAL COMMUNICATION CHANNELS IN A CENTRAL FACILITY/LOCAL FILING SYSTEM



The solid lines indicate the minimum number of communication channels a Louisiana-type system would require. There is only a single link between each filer and each clerk on the assumption that any filer will likely file with only one clerk, probably the nearest one, to minimize travel or communication costs. The dotted lines added to connect each filer with each clerk are those communications channels that filers might rationally use were the clerks truly in competition with each other. In that case, each filer might have occasion to deal with each clerk, assuming that each would, on occasion, offer superior competitive terms. The additional dotted lines, from each searcher to each clerk, similarly indicate the extra communication channels potentially required in a networked search system.

Thus, one might argue that the filing system is a natural monopoly—that the services it provides are producible at continuously declining marginal costs, because the central monopolist organization requires the fewest communication channels. If the marginal costs of a practical, centralized system are substantially lower than the marginal costs of a practical, networked system, the price for the services charged by a monopolist may in fact be lower than a truly competitive price, be-

cause the cost of the competition is the maintenance of expensive but unnecessary communication links. That argument, however, is not obviously a winner. Just what constitutes a "communications channel" is unclear. For example, our current network of telephone lines may permit one to argue that the costs of the extra channels are largely "sunk" rather than marginal costs, in which case communication costs do not create a natural monopoly.

IV. OPTIMAL ORGANIZATIONAL RESPONSES TO TECHNOLOGICAL MONOPOLIES

If a centralized system entails continuously declining marginal costs, one might argue that the filing system, organized as a state monopoly, is economically justifiable. Nonetheless, there is good theoretical reason to believe that there are superior ways in which to organize the use of a technology that produces natural monopolies.

A. THE POSSIBILITY OF A COASEAN AUCTION

In the 1950s, Ronald Coase first proposed, in the case of licenses to use the electromagnetic spectrum, that the grant of property rights could efficiently be auctioned off rather than awarded through the political process.⁴⁶ The gravamen of his position was simple: The highest bidder at any auction was likely to be the person or firm valuing most highly the particular property rights. The auction technique thus would tend to result in resources finding their way into the hands of the highest valuing users, a feature of any optimal distributive system.⁴⁷

We probably cannot get too excited, however, about the prospect of awarding a franchise to the highest bidder for the rights to collect the rent-seeking profits from the UCC filing system. The current system, which awards the rents to democratically elected politicians, might not tend to arrive at the same place as an auction, although to the extent that elections are won by those willing to invest the most in campaigning for office,

46. R.H. Coase, *The Federal Communications Commission*, 2 J.L. & ECON. 1, 35-40 (1959).

47. Because the person who can operate the system at lowest cost is likely to be among those who will profit most from owning it, the auction also tends to deliver resources into the hands of those who have low costs of transforming them into valuable outputs.

the differences between the current system and one privatized by auction may not be especially significant.⁴⁸

B. ALTERNATIVES TO THE COASEAN AUCTION

Coase's ideas, however, reveal another possibility. If we were to reconceptualize our goals for the system so that our wish is that the services of the filing system, justifiable or not, at least be delivered at a price approximating their marginal cost, the auction technique is still a viable alternative. If the state were not interested in using the auction to raise the maximum amount of sales proceeds from the award of property rights, but, instead, desired an efficient allocation of resources, it might choose not to award to the highest bidder, but rather to the bidder promising to charge the lowest prices to filers and searchers. So long as bidders in such a system were bound to provide the services at the prices they specified in their bids, the winning bidders will tend to come from the set of lowest cost service providers, and the services will tend to be provided at prices approximating their anticipated marginal costs.⁴⁹

To suggest that we can design an auction that will tend to create incentives for the optimal provision of filing services is not to say that the engineering problem is trivial. Among other things, the auction would have to be organized to create a detailed description of the services that the winning bidder was obliged to provide. As does any bidder who is awarded a fixed-price contract, the bidder winning a low-price auction would emerge with a strong incentive to chisel on the actual value of the services it provides. Unless the services were defined in detail, for example, the winning bidder could offer to provide them, but only after long delays, unless future users of the system agree to pay bribes to guarantee timely receipt of the services.

An auctioning off of the filing system to the private party promising to deliver its services at the lowest price does not com-

48. Cf. RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 39-41 (3d ed. 1986) (arguing that competition for broadcast licenses in the administrative arena, which tends to deliver broadcast rights to those willing to pay the most in fighting costs, produces results much like those of an initial auction, but less efficiently).

49. I owe this thought to John Bigelow. Bigelow also believes that the low-price bidder will include some insurance premium in his bid price to provide for the uncertainty that his estimate of future marginal costs will be in error. That the filers must pay not only the present marginal cost of the service, but also for the risk imposed on the contractor who runs the filing archives, however, is not a serious departure from the conditions of optimal provision of the services of the system.

pletely assure us that the natural monopoly problem has effectively been solved, however. With their prices fixed by the legislature, today's local clerks and central secretaries of state have incentives to economize on the costs that they might incur,⁵⁰ just as would the winning bidder in the low-bid-price-wins auction. The ceiling on prices, however, removes one other important incentive that we might wish to have influence the operator of the filing system. An entrepreneur has every reason to cut costs, even if that means firing his or her brother-in-law. He or she also has an incentive to improve the product to make it more valuable to consumers, but only if he or she has the latitude to charge for the increased value being delivered.

The technological issues that plague the current system—what is the optimal place to file, under what name, how information is disclosed if collateral becomes proceeds, and the like—all involve the issue of making the system more valuable to its users. We can sit in our law school libraries and speculate on what version of these possibilities the users of the system actually want and would be willing to buy, but as long as none of us has to put up any money to make it happen—we stand to lose nothing if our speculations are inaccurate—there is not any particular reason to credit our speculative insights as being worth very much.⁵¹

CONCLUSION

In summary, it is possible, by various auction techniques, to create filing systems that are apt to create more efficient outcomes than the existing system, because they create the appropriate incentives for those who own and operate the system. Neither of the two most obviously beneficial types of auctions, however, create a full array of the appropriate incentives. Thus,

50. Note that the clerks in a Louisiana-type system, who get to keep the savings from any economizing measures they develop, and can use them to hire more of their in-laws, have stronger incentives to minimize costs than do the Minnesota clerks who must remit all their funds to the legislature and beg for funding to cover the costs of their operations.

51. That people's perceptions of reality are greatly sharpened when they have money on the line is colorfully illustrated by an experiment in predicting the outcome of elections. Researchers have created "electoral stock markets," which permit investors who estimate election outcome by percentage of votes won by both candidates to earn large returns based on how accurate their predictions turn out to be. The "market" price winning percentages tend to be more precisely accurate than the results of ordinary scientific polling. See Richard Morin, *For Those Who Think Politicians Can Be Bought and Sold*, WASH. POST NAT'L WKLY. ED., Feb. 7-13, 1994, at 37.

while privatization can improve the efficiency of the system, it cannot cure all its defects. If the system can be improved, however, it should be, even if the improvements do not yield perfect results. Nevertheless, because all organizational improvements have suboptimal facets, there is good reason for eschewing them in favor of abolishing the filing requirement altogether.

